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Top Ten Business Income Tax Planning Ideas During the Age of COVID-19

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Executive Summary

Three deeply experienced tax professionals based in our New York City office share useful tax planning ideas for business owners. By leveraging these strategies, companies can improve their cash position and create refund opportunities.

While technically focused, this white paper offers practice advice for business owners and in-house accounting staff.

Reconsidering the approach to inventory, tax planning, equipment, stock and debt, and foreign operations, can unlock cash flow and positively impact a company's financial position.

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During this time period when all businesses want to maximize cash for operations, some of the most basic tax planning ideas warrant the attention of all business owners. These “oldies but goodies” in the tax planning bucket can make a significant difference in reducing income tax, thereby increasing cash flow and even creating tax refund opportunities. Many of these can be used on 2019 tax filings not yet completed.

Examine All Business Receivables to Determine if a Write-Off can be Taken

An accrual basis business can take an ordinary deduction for the write-off of a business bad debt (Sec. 166(a)). Care must be taken to ensure that the amount due cannot be recovered, otherwise the actual collection of the receivable will create taxable income in a later year.

The worthlessness of a debt is a determined by the particular facts surrounding each debt. The regulations do not contain a specific definition of the term “worthless”. The judicial standard for this determination is more pragmatic than it is legal. Court cases often rely on what could be considered sound business judgment in determining. worthlessness (See Estate of Mann v. United States, 731 F.2d 267 (5th Cir. 1984)).

Legal action is not required in order to determine if a receivable can be written-off. Instead, if all the facts and circumstances indicate that legal action may not be effective, there is enough basis to write-off the debt.

The bad debt deduction is only allowed for any debt which becomes worthless within taxable year for which the deduction is taken. Therefore, two determinations need to be made to support the write-off of a business receivable. Both the actual worthlessness of the debt and the fact that the debt became worthless in the year that the deduction is taken.

A deduction can be taken if the receivable is partially worthless (Sec. 166(a)(2)). It is permissible to take a partial worthless bad debt deduction as a receivable become worthless. On the other hand, a business can also defer the deduction to a later year when partial worthlessness is greater, and, take the accumulated amount in one year. The amount written-off in any year must also be charged-off on the entity’s books and records. Furthermore, the business can defer any deduction taking the deduction until the year that it is totally worthless. However, the deduction cannot be postponed beyond the year of total worthlessness (Reg. Sec. 1.166-3)).

Use the Lower of Cost or Market Method (LCM) for Valuing Inventory

The LCM method of inventory valuation can result in the current write-downs of inventory costs before the sale of the inventory (Reg. Sec. 1.471-4). The method can be used by a distributor or a manufacturer of products. However, it is not available if the LIFO method of inventory is used.

Each item of inventory must be considered separately to determine the proper inventory value. This requirement prevents a business from using a percentage write-down approach that is be permitted for accounting purposes.

For goods purchased to be resold, the term “market” means the current bid price (replacement cost) at the date of the inventory for the product purchased in the usual volume. In today’s turbulent economic times, obtaining this value presents a problem if the business’ normal source of supply is inaccessible. The Tax Court has held that the current bid price is the prevailing price in the market available to the taxpayer (D. Loveman & Son Export Corp. v. Commissioner 34 T.C. 776 (1960), acq., 1961-2 C.B. 5, aff'd, 296 F.2d 732 (6th Cir. 1961), cert. denied, 369 U.S. 860 (1962)). Therefore, if normal circumstances due not exist as a result Coronavirus factors, the business uses the prevailing market in the LCM calculation. It is important to emphasize that the market value is determined at the date of the inventory (Reg. Sec. 1.471-4(a)(1)).

With regard to manufactured products, the market value is to the manufacturer is measured by the costs to replace the inventory in the same manner as it was produced. This includes direct labor, direct material, and indirect costs including those required under the under Sec. 263A, the uniform capitalization rules for inventory (Reg. Sec.1.474-4(a)(1)).

Corporations Can Apply for a Refund of Excess 2019 Estimated Taxes Before the 2019 Tax Return is Filed

During this economic downturn, cash can be a bit tight, it is important to realize that an overpayment of 2019 corporate estimated taxes can be received before the actual filing of the corporate tax return.

Form 4466, Corporation Application for Quick Refund of Overpayment of Estimated Tax, can be filed before the 2019 tax return is filed and the IRS will refund the claimed overpayment within 45 days (Reg. Sec. 1.6425-1(b)(1)). This can be a very valuable tool to use during this period where there may be delays in gathering all the information for a complete preparation of the 2019 tax return.

The form can be used for several types of corporate filings including a Form 1120 and Form 1120F. In past years, a calendar year corporation which files Form 1120 would have to file Form 4466 to apply for a quick refund of 2019 estimated taxes by April 15, 2020.

However, the IRS recently extended this due date to July 15th and therefore the opportunity to receive a quick refund of an overpayment of 2019 estimated taxes before the filing of the tax return is still available.

The form simply asks for the expected tax on the eventual return and the estimated taxes paid, including any overpayment carried over into 2019 from a prior year. Details must be given for the dates of payments and the amounts paid, which the IRS will verify. In order to apply for this quick refund, the estimated tax overpayment must be both at least 10% of the expected tax liability and at least $500.

One caveat: Care should be taken in determining the expected tax on the return to be filed. If the amount requested is “excessive” compared to the ultimate tax on the return, a penalty will be assessed.

Depreciating Idle Equipment

It is entirely possible that as a result of reduced demand in the current economy that manufacturers find themselves with property that becomes idle.

Depreciation is allowed on assets that are temporarily idle, provided the taxpayer can demonstrate an intention to devote them to active use as soon as conditions permit This is referred to as the “idle asset “ rule. Under this rule the right to depreciation continues until the property is abandoned or otherwise disposed of. As a result of the rule, even though certain depreciable property may be idle as a result of decreased demand, the property can still be depreciated because it is still considered to be “placed in service”. The property simply must be in a condition that is ready for use once the market picks-up again (Sampson Inv. Co v Cir 76 TCM 158, 170).

An Ordinary Deduction for Worthless Stock of a Subsidiary

An opportunity exists for a corporation to take an ordinary, not capital, loss when the stock of an “affiliated entity” becomes worthless (Sec. 165(g)(3)).

There are certain requirements to obtain such a beneficial tax deduction. First, for the worthless entity to be “affiliated,” the stockholder must own stock representing at least 80% of the voting power and at least 80% of the value of the entity's stock. Second, 90% of the subsidiary's aggregate gross receipts for all tax years during which the subsidiary has been in existence must be from sources other than: royalties, rents dividends, interest, annuities, or gains from sales or exchanges of stock and securities.

The ordinary loss opportunity applies to a domestic or foreign subsidiary. The business does not need to be disposed of to obtain the loss. However, there must be an identifiable event that occurs in order to take the loss. For example, an election to change the

classification of an entity from a corporation to a disregarded entity could give the shareholder an ordinary deduction if the fair market value of the subsidiary's assets is less than the entity's liabilities. The shareholder receives no payment on its stock reflecting the entity's worthlessness. Another identifiable event may be the liquidation of a subsidiary, which does not qualify under Sec. 332 of the Code. More specifically, the liquidation would not qualify under that section if no money is paid to the parent for the stock of the subsidiary.

Ensure Adequate Stock and Debt Basis in S Corporations and Partnerships

Much has been written about the provisions in the CARES Act that can result in increased deductions and potential refunds of taxes paid. These include, the technical correction to the depreciation provisions for Qualified Improvement Property, the increased interest deduction under Sec. 163(j) and the NOL carryback provisions. However, if these relief provisions are generated through partnerships or S corporations, the partner/shareholder must have adequate tax basis to take any deduction or loss that flows through from the entity in order to benefit in the current year from these favorable provisions.

A basis calculation for shareholders and partners consists of a running computation of from the point in time when the owner obtained an ownership interest in the entity and must be updated each year to reflect all of the relevant activity that impact basis. It is important to have the calculation completed to the extent possible before year-end to determine if additional basis needs to be created with additional capital contributions or loans before the end of the year.

The rules for debt basis in S corporations are much different and more limiting than those for partnerships. Specifically, for an S corporation shareholder to receive basis for debt of the entity, the shareholder must have made the loan directly to the entity (Sec. 1366 (d)(1)). Loans to an S corporation from third parties, even from another entity that the shareholder owns, do not create tax basis in the resulting S corporation debt. In addition, a shareholder’s guarantee of an S corporation debt does not create tax basis. In contrast, partners do get basis from third-party loans to the partnership (Sec. 752(a)).

An interesting opportunity exists for computing S corporation basis for an S corporation that receives a loan under the Paycheck Protection Program instituted under the CARES Act (PPP Loan). These loans can be fully forgiven if 75% of the loan proceeds were used for payroll costs, and 25% were used for overhead expenses, like mortgages and rent payments, as well as utility costs. For an insolvent company, forgiveness of debt is not considered tax-free income of the type that increases the stock basis in an S corporation (Sec.108(d)(7)(A)). However, it does appear that an S corporation that is not insolvent when its PPP loan forgiven, can receive an increase in basis for the forgiveness. That said, this benefit should be monitored for any ruling by the IRS to the contrary.

It is also important to remember that with regard to taking losses for debt, the shareholder or partner must be “at-risk” with regard to the debt. Limited partners of partnerships are not at economic risk of loss for recourse liabilities and thus are not allocated a share of such liabilities for tax basis purposes. Conversely, a shareholder’s at-risk amount for an interest in an S corporation includes the amount of money and the adjusted basis of other property contributed to the activity, as well as certain loans made to the S corporation by the shareholder. The determination of whether the shareholder is at-risk depends on numerous factors, including the source of the funds loaned and the security given for the loans (See. Sec. 465 Traps for the Unsuspecting S Corporation Shareholder, by Lewis Taub, CPA. The Tax Adviser July 1, 2010).

Consider an Automatic Change in Accounting Method to Reduce Taxable Income

Automatic changes in accounting methods can be made by the due date of the tax return, including extensions. Therefore, it is not too late to consider such changes to reduce 2019 taxable income. Note that while these changes may possibly only have a benefit in the year of change, such changes reflected on the 2019 tax return could result in significant tax savings on the 2019 tax return and possibly an NOL to be carried back or forward.

Revenue Procedure 2018-31 includes a list automatic changes in accounting methods. This Revenue Procedure should be reviewed to determine which can apply on a case by case basis. Some very common ones which are relevant to a wide range of businesses include:

- Changing the treatment of prepaid expenses - Deduct prepaid expenses when paid using the “12-month rule” (Regs. Sec. 1.263(a)-4(f));
- Changing the treatment of accrued compensation – Deduct the amounts that are fixed and determinable at year end and are paid within 2½ months after year end (Regs Sec.1.461-4);
- Changing the treatment of advanced payments received- Defer the receipt of such payments to the subsequent year (Rev. Proc. 2004-34, Code Sec. 451(c), Rev. Proc. 2019-37, Prop. Regs. Sec 1.451-3);
- Review the class-lives used for the depreciation deduction - Often the class lives utilized are simply incorrect and result in prolonged depreciation lives which can be significantly shortened on review; and
- Review the application of the Uniform Capitalization Rules regarding inventory ., Is there overcapitalization? Are percentages used in the “simplified method” overstated based on changed circumstances?

Consider Repatriating Excess Cash from Foreign Operations

U.S. multinational businesses that may now be facing liquidity or cash-flow challenges should consider repatriating excess cash from their foreign entities provided the foreign entities have the requisite distributable reserves/retained earnings to do so under local law.

In many cases, the cash to be distributed may have already been subject to U.S. tax (for 10%-or-greater U.S. shareholders) as a result of, for example, the one-time transition tax implemented under the 2017 Tax Cuts and Jobs Act (TCJA) and imposed by Sec. 965. That is, the transition tax generally applied to the U.S. shareholders' portion of the post-1986 earnings and profits (E&P) of a controlled foreign corporation (or of another foreign corporation having a U.S. corporate shareholder with at least 10% ownership), and applied irrespective of whether the foreign E&P was actually distributed to the United States. As a result, the foreign E&P became foreign previously tax earnings and profits (PTEP).

Thus, business owners should determine whether their foreign operations have any PTEP that could be repatriated because such PTEP would be accessed first upon an actual cash distribution (see Notice 2019-1 and Treas. Reg. Sec. 1.960-3(c)). Corporate shareholders have the option of accessing foreign cash in excess of this PTEP because foreign earnings accumulated since 2017 can be repatriated to its U.S. corporate shareholder and generally receive a full dividends-received-deduction (i.e., exempt from U.S. taxable income) as a result of the TCJA. This tax reform provision was not extended to individual and pass-through entities, so the prospect of repatriating PTEP to individual and/or pass-through entities has much greater appeal.

It is also important to note that shareholders of S corporations that made a timely Sec. 965(i) election in 2018 to defer the one-time transition tax until such time the S corporation has a "triggering event" (as defined in Sec. 965(i)(2)) may have a potential opportunity to repatriate the foreign earnings to the S corporation without triggering a federal income tax liability. While not free from doubt, this should be the case even though the foreign earnings have not technically been subject to U.S. tax yet. It should be noted, however, the cash distribution would likely be subject to the 3.8% net investment income tax and the impact of any foreign currency gain or loss must be analyzed.

Re-evaluate Transfer Pricing Arrangements

It has become clear that the economic impact of the COVID-19 pandemic will run deep as businesses face reduced sales and profit margins, reduced cash flow – whether for the U.S. parent business or the foreign subsidiary, and/or revised customs declarations or adjustments. From a transfer pricing perspective, internal cross-border pricing policies for goods (manufacturing, distribution, and/or sales), services, royalties, and/or interest

on financing may no longer be relevant (or “in-range”) due to the significant business disruption resulting from COVID-19.

Traditionally, transfer pricing has provided a mechanism to realign income streams or expense categories to tax-favorable jurisdictions. COVID-19 has not necessarily provided U.S. multinationals an opportunity to shift tax burdens between jurisdictions but instead, arguably, an opportunity to minimize economic damages resulting from this global pandemic. By no means are we suggesting that current intercompany policies and benchmarking analyses, etc. are worthless, but instead proactively re-evaluating the functional analysis, the changes in business industry, extraordinary items resulting from severance and/or shutdowns, new functions and risks inherent in the business, to rationalize and support modifying such intercompany pricing to maximize cash flows where they are most needed.

One area that could warrant a “fresh look” (only for C corporations) is property sold and/or services provided by the U.S. business to its offshore affiliates and the resulting foreign derived intangible income (FDII) to the U.S. corporation. FDII is the amount of a corporation's deemed intangible income that is attributable to sales of property to foreign persons (including foreign affiliates) for use outside the United States. It can also apply to the performance of services for foreign persons or with respect to property outside the United States. Coupled with the 21% tax rate for domestic corporations as a result of the TCJA, the FDII deduction results in a potential 13.125% effective tax rate on FDII. Given the global economic disruption, it may be more palatable depending on re-tooled functions and risks to increase the price charged by the U.S. parent corporation to its foreign affiliates for certain goods or services. This allows the U.S. parent to increase its cash flow (from the foreign affiliates) while subjecting the incremental income to a (lower) 13.125% tax rate (Sec.250(a)).

Another area to consider is intercompany loans and evaluate whether it makes sense to either capitalize some or all of the intercompany loans or reset the interest rate in the notes to ease the pressure on the foreign affiliate to make timely principal and/or interest payments to the U.S. parent company.

Utilizing an IC-DISC to Minimize the Tax on Exports

If a pass-through entity is engaged in any of the following activities:

- ✓ Directly exports goods it manufactures.
- ✓ Provides architectural or engineering services that are conducted in the United States for a building/bridge built outside of the United States. .
- ✓ Manufactures a good that is included in a product that is exported by someone else.

the business could be an ideal candidate for an IC-DISC (Interest Charge – Domestic International Sales Corporation) The setup and use of an IC-DISC is extremely easy and low-maintenance. It should be noted that albeit a true "oldie but goodie," it can only be used prospectively (i.e., no opportunity for tax refunds from prior years) as soon as the entity is formed with zero impact on the supply chain and invoicing functions.

In a nutshell, an S corporation pays a fully deductible commission to its IC-DISC for its export services. The IC-DISC is not taxed on the commissions received. The IC-DISC turns around and pays a dividend to the S corporation shareholder in the same year (or early the year thereafter). The tax advantageous result is simply a function of tax rate disparity between ordinary income tax rates and those on qualified dividends – that is, ordinary tax rate operating income of the S corporation is converted (in an amount equal to the commission) to lower tax rate qualified dividend income coupled with an ordinary tax deduction for the S corporation on the commission paid.

There are two administrative pricing methodologies that are typically used to determine the amount of the commission:

1) 4% of qualified export receipts; or

2) 50% of combined taxable income (CTI) pertaining to export sales.

The business has flexibility in utilizing the method that produces the maximum tax benefit. It can be done on a year-by-year basis and could even be done on a transaction-by-transaction basis.

The following key qualifications must be adhered to:

1) The IC DISC must be a separate legal entity formed in the United States with a single class of stock AND a minimum capitalization of $ 2,500;

2) Export "property" must be 50% or more U.S. content (i.e., more than 50% of the value of exported property cannot be from imported materials); and

3) Qualified exports must be at least 95% of the total assets of the IC-DISC.

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The Take-Away

In these challenging economic times, it is extremely worthwhile to review many of the classic tax saving opportunities that have provided a significant reduction of taxes during a wide range of economic conditions. While the recently enacted CARES Act contains several significant tax saving opportunities, a great deal of needed cash can be generated by applying the tried-and-true tax provisions which have been used by tax planners for many years The possibilities are not limited to just the ones noted in this article. Therefore, it is essential to review all the circumstances of each business to determine “oldies but goodies” that are relevant in each set of circumstances.

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